The Impact of the Federal Reserve's Interest Rate Target Announcement on Stock Prices: A Closer Look at how the Market Impounds New Information

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Abstract

The Federal Reserve announces its new interest rate target while the stock market is open, at precisely 2:15 P.M. eight times a year. In the Efficient Markets model, information is impounded in prices immediately and accurately as soon as it becomes public knowledge and only the unanticipated portion moves prices. Responding accurately to news requires investors to judge how much other investors have been surprised and how their investment decisions will be affected, so how the market responds to the news generates additional information to be digested and acted upon. This suggests that the full process of returning to equilibrium can not be instantaneous. In this paper, we combine a non-model dependent procedure for extracting the market's risk neutralized probability density over future stock prices from a set of option prices, with a newly available real time options data set, in order to examine the informational microstructure of the stock market around Fed funds target announcements.

Keywords: risk neutral density, Fed funds target announcement, efficient markets

JEL Classification: G14, G13, D84

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